

Cite as Det. No. 05-0325, 27 WTD 99 (2008)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

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| In the Matter of the Petition For Correction of |) | <u>D E T E R M I N A T I O N</u> |
| Assessment of |) | |
| |) | No. 05-0325 |
| |) | |
| ... |) | Registration No. . . . |
| |) | Doc. No. . . . /Audit No. . . . |
| |) | Docket No. . . . |
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RULE 155, RULE 245; RCW 82.04.065; ETA 544: RETAILING B&O TAX VS. SERVICE B&O TAX -- CLASSIFICATION OF INCOME -- PRIMARY NATURE -- ELECTRONIC INSURANCE CLAIMS PROCESSING. In determining the proper classification of a taxpayer's income, we will consider the "primary nature" of the taxpayer's activities. If the primary nature of a taxpayer's activities was the transmission for hire of data via a telephone network or similar transmission system, the taxpayer's income would be subject to retailing B&O tax, and the taxpayer would be required to collect retail sales tax from its customers. In contrast, if the primary nature of the taxpayer's activities was information or internet services, the taxpayer's income would be subject to service B&O tax. Taxpayers, who provided electronic insurance claims processing services were providing information services subject to service B&O tax; however, separate charges for telephone lines, and canned software were properly classified under the retail classification and subject to retail sales tax.

Headnotes are provided as a convenience for the reader and are not in any way a part of the decision or in any way to be used in construing or interpreting this Determination.

STATEMENT OF THE CASE:

C. Pree, A.L.J -- Taxpayers, who provide electronic insurance claims processing services, petition for correction of assessment. The Audit Division concluded that the taxpayers provide

network telephone services subject to retail sales tax and retailing B&O tax and issued an assessment accordingly. We conclude that the taxpayers provided information services subject to service B&O tax; however, separate charges for telephone lines, canned software, and other items are properly classified under the retail classification and subject to retail sales tax. We remand the assessment to the Audit Division to allocate the taxpayers' income between retailing and service and to apportion the taxpayers' service income.¹

ISSUE:

Did the taxpayers, who provide electronic insurance claims processing services, provide network telephone services subject to retail sales tax and retailing B&O tax or information services subject to service B&O tax?

FINDINGS OF FACT:

The Audit Division of the Department of Revenue reviewed [Company A's] records for the period of July 1, 1998, through May 31, 1999. [Company A] was acquired by [Company B] effective June 1, 1999. The Audit Division reviewed [Company B's] records for the period of January 1, 1997, through December 31, 2000.

With respect to the issue here, [Company B] and [Company A (together "the taxpayers")] perform similar functions, *i.e.*, they act as electronic intermediaries between their customers and insurance carriers. Specifically, they sell software license and maintenance services, which enable their customers to determine the insurance coverage of their customers (*e.g.*, co-payment amounts and whether the prescribed drug is reimbursable under the particular insurance plan), and the taxpayers submit insurance claims on behalf of their customers. . . .

The taxpayers have access to the insured's medical information from various insurance providers, which enables the taxpayers to provide insurance claims processing on a real-time basis. In providing these services to their customers, the taxpayers relay insurance coverage information to the customer and the claims data to the insurance carrier. The taxpayers do not have access to the insurance carrier's computers and have no input into the decision regarding whether to accept or deny insurance coverage. The insurance carrier processes claims and determines whether to authorize or reject a claim, and the taxpayers inform the customer of the insurance carrier's decision.

The transactions typically occur as follows. A customer needing a prescription filled provides a pharmacist with the prescription and the customer's medical insurance information. The pharmacist enters the information into a terminal, which is owned or leased by the pharmacy.

¹ Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410. Nonprecedential portions of this determination have been deleted.

Using the taxpayers' licensed software, the terminal connects in real-time to the taxpayers' out-of-state operations center.

When the taxpayers receive the data from the pharmacy, their computers sort the data by insurance carrier and reformat the data to comply with the insurance carrier's claims processing requirements. The reformatting entails ensuring that the information is on the correct line and that sufficient information has been provided. If data are missing or incorrect, the taxpayers request complete, correct data from the pharmacy. The taxpayers reformat the data to ensure the successful transmission of the insurance claim to the appropriate insurance provider. The taxpayers then connect with the insurance carrier's information system (primarily through dedicated lease lines) and deliver the request. The insurance claim is typically filed at this time.

The taxpayers reject claims before they go to the insurance carrier if the claim does not meet . . . guidelines (which involve the proper communication language) for electronic claims processing,² if the claim is from a pharmacy that is not one of the taxpayers' customers, or if the taxpayers do not have a relationship with the insurance carrier (which is rare). Sometimes, due to technical limitations, the insurance carrier may not be able to accept a real-time insurance claim submission. In these instances, the taxpayers will either submit a batch claim on a daily basis or at intervals agreed upon by the pharmacy.

After the insurance carrier responds to the claim, the taxpayers sometimes perform additional sorting and reformatting and deliver the response from the insurance company to the pharmacy.

The taxpayers' services are accomplished via a modem and phone line, over the internet. Thus, these services require the use of telephone lines to transmit data between the taxpayers and their customers. For an additional monthly charge, the taxpayers will obtain the telephone link for their customers. This monthly charge may be either fixed or variable, and is based on the taxpayers' telecom costs. The costs are [a very small amount] per transaction and comprise [a small percentage] of the taxpayers' total charges to pharmacies . . . , hospitals and medical clinics. Rather than having the taxpayers obtain the telephone link, the customers may arrange for their own telecom connectivity to the taxpayers. The latter option is selected by some of the taxpayers' large customers.

The taxpayers' computer networks capture the data necessary for billing their customers and for providing reports to customers of their transaction activity (such as total transactions and accepted and rejected transactions). The taxpayers' computer operations center monitors the sorting and reformatting of the data for each transaction and monitors the telecom connectivity (where applicable) to ensure that the third-party telecommunications provider maintains connectivity.

² The taxpayers do not change the communication language of the data, *i.e.*, the taxpayers' function is not to make their customer's language compatible with that of the insurance company.

The taxpayers' service virtually eliminates manual processing of paperwork. The reduction in paper claims results in time savings and lower administrative costs for the taxpayers' customers, as well as improved cash flow by streamlining the claims reimbursement process.

For an additional charge, in addition to the basic claims service described above, [Company B] provides pre and post edit premium services. These services allow its customers to impose business rules on their transaction submissions and responses and to monitor the claims process, which are intended to increase the customers' cost savings or income. These services include alerting the pharmacist regarding whether the [drug's code] number is current, a generic drug is available, and the submitted prescriber ID is valid; and alerting the customer regarding drug limitations or restrictions. These services also include allowing the customers to remotely access [Company B] databases to examine their transaction details and history, to capture financial response information to ensure that the customer is reimbursed at an acceptable level, and to determine if their charges to their customers are comparable to other pharmacies in their market area.

For an additional charge, in addition to the basic claims service described above, [Company A] provided "audit" services to increase productivity, recover revenue, improve billing accuracy, maximize reimbursement, and reduce customers' administrative costs. The additional services included online verification of reimbursement, online laboratory requisitions, results reporting, and automated flagging of abnormal results (a quality control service). In addition, through various software packages, [Company A] offered . . . services, which were designed to improve the recovery of lost revenues, and provide feedback regarding managed care contract management and negotiations.

The taxpayers' charges to their customers typically include transaction service charges, which are broken down based on the payer contacted and the number of times each payer was contacted; real time switching charges, which are comprised of dial up charges and lease line charges on a per-transaction basis; and lease line charges for one-time installation costs. The taxpayers also charged software license fees and [fees] for software installation. The Audit Division characterized all of these transactions as retail sales. With respect to the software charges, the Audit Division cited WAC 458-202-155 (Rule 155), which characterizes sales of canned software as retail sales. With respect to the remaining charges, the Audit Division concluded that the taxpayers provided network communications, *i.e.*, the transmission of data for hire, which is a retail activity. The Audit Division explained, "The primary purpose of the transmission charges billed to [the taxpayers'] customers, is for the transmission of electronic data via a secure, confidential means."³

³However, in a prior audit of [Company A], the Audit Division taxed the "electronic interchange" transactions *i.e.*, the electronic insurance claim processing, under the service classification. In the current audit of [Company A] the Audit Division accepted this income as reported under the service classification. However, [Company B] was instructed to report this income under the retailing classification and to pay retail sales tax effective September 1,

The Audit Division agreed with the taxpayers that some of their charges were properly subject to service B&O tax. Specifically, the Audit Division concluded that income [Company A] received from the audit services described above, as well as consulting services and training, were properly subject to Service B&O tax. In the [Company B] audit, the Audit Division determined that transaction charges for point of sale insurance coverage information⁴ and charges for pre and post edit services and other similar activity was subject to service B&O tax, when separately stated from the transmission charges. The taxpayers, on the other hand, contend all of their income is subject to service B&O tax and, accordingly, apportionable.

ANALYSIS:

The issue in this case involves the proper B&O tax classification of the taxpayers' income. The Audit Division contends the taxpayers' income is properly taxed under the retailing classification (and subject to retail sales tax) either because it involves a license to use canned software or because it involves "network telephone services." The taxpayers, on the other hand, contend their income is properly subject to the service classification either because it involves "computer services" or "internet services."

In determining the proper classification of the taxpayers' income, we will consider the "primary nature" of the taxpayers' activities. *See, e.g.*, ETA 544.04.08.245 (ETA 544); Det. No. 04-0023E, 23 WTD 206 (2004). ETA 544 explains, "The Department considers the primary nature of the activity in establishing the tax classification applicable; Incidental services of a possibly different classification, unless clearly identified and billed, will not affect the tax classification so established." Thus, the ETA concluded, a telephone answering service is not generally engaged in network telephone business activities, even though some of the activities it performs, when isolated from the primary or general business activity, would satisfy the retail sale definition. The ETA continues:

As a general practice, when no itemized or separate billing for manual or electronic switching, cross connecting, cross accessing, or other possibly retail service is provided, the Department will not impute or allocate any such charges or itemization from the gross services billed by the telephone answering service business. The telephone answering business would continue to be liable for Service business and occupation tax on all its gross receipts.

However, if the Department determines that the primary nature of the activity has become one of retail services, as outlined above, warranting thereby a reclassification of tax, or that incidental retail services such as manual or electronic switching or cross connecting of lines

2002, based on the Audit Division's conclusion that these services were properly characterized as network telephone services.

⁴ This information allows the pharmacist to check insurance coverage, but does not entail the submission of a claim.

and networks are separately billed, the receipts of such clearly identified retail activities will be taxed as retail sales, subject to the Retailing business and occupation tax and retail sales tax.

(Emphasis original.) We will next analyze each of the classifications set forth above to determine which best represents the “primary nature” of the taxpayers’ activities and whether the taxpayers separately billed any incidental services, which should be taxed under a different classification.

Information Services. Gross income from “computer services” is subject to tax under the service classification. WAC 458-20-155 (Rule 155); *see* RCW 82.04.290. Rule 155 defines “computer services” as “every method of providing information services through the use of computer hardware and/or software.” Rule 155, in turn, defines “information services” as follows:

every business activity, process, or function by which a person transfers, transmits, or conveys data, facts, knowledge, procedures, and the like to any user of such information through any tangible or intangible medium.

The term does not include transfers of tangible personal property such as computer hardware or standard prewritten software programs. Neither does the term include telephone service defined under RCW 82.04.065 and WAC 458- 20-245. . . .

Network Telephone Services. Generally, persons rendering “telephone service” to consumers are taxable under the retailing classification and are required to collect retail sales tax from their customers. *See* RCW 82.04.065; WAC 458-20-245 (Rule 245). Telephone services include “network telephone service,” which is defined as follows:

“Network telephone service” means the providing by any person of access to a telephone network . . . , or the providing of telephonic . . . , data, or similar communication or transmission for hire, via a telephone network, toll line . . . , or similar communication or transmission system. “Network telephone service” includes the provision of transmission to and from the site of an internet provider via a telephone network, toll line . . . , or similar communication or transmission system.

RCW 82.04.065; *see also* Rule 245. Thus, as the Audit Division contends, if the primary nature of the taxpayers’ activities was the transmission for hire of data via a telephone network, such income is subject to retailing B&O tax, and the taxpayers would be required to collect retail sales tax from their customers.

The Audit Division noted that the taxpayers provide their customers with a telecommunications link to access a local taxpayer network. According to the taxpayers, the Audit Division reached this conclusion because the taxpayers offer each customer “the convenient option of having [the

taxpayers] obtain the underlying telecommunications service required for its Internet connectivity. When [taxpayers'] customers select this option, [taxpayers] allocate a percentage portion of the underlying telecommunications costs of such connectivity to each customer in the form of a monthly fee." The taxpayers admit that their Internet-based services require the use of telephone lines to transmit data between them and their customers, but argue the "true object" of their services is not the use or provision of telecommunication services, or the mere "transmission of data" as suggested by the Audit Division, but that such service is merely incidental to their various medical information services. The taxpayers argue that their primary service streamlines the claims submission process by compiling health insurance, medical provider, and billing information, and making such information, via the Internet, readily available to the medical professional for timely, accurate prescription servicing and subsequent insurance claim processing.

The taxpayers characterize their business as "perform value-added, Internet-based data processing services . . . that provide . . . medical professionals with 'instant access' to various medical insurance information, and thereafter provide such medical professionals with a fully automated, error-free insurance claims submission process." The taxpayers emphasize that their customers do not believe that they are contracting for a network telephone service because a local or national telecommunications company "undoubtedly already provides such services to them." Instead, the taxpayers argue, their customers "contract for convenient, efficient, medical data processing services that allow medical professionals to focus on their core competencies." The taxpayers emphasize that they are not in the business of "merely transmitting data"; instead, they are "in the business of collecting processing, and manipulating data, as a convenience for . . . customers." The taxpayers reason that to provide this service, data must necessarily be transmitted via some medium, but the taxpayers do not provide "access" or "medium" to its customers within the scope of RCW 82.04.065. "Rather," the taxpayers note, "such access is provided to [Company B] as a vendor who merely utilizes the services of a telephone company or Internet service provider in order to perform its own service for its customers."

The Audit Division further characterized the taxpayers' exchange of data in real-time with their customers as transmitting data for hire, as contemplated by RCW 82.04.065. The Audit Division concludes the taxpayers are "clearly . . . hired to transmit data or information for hire . . . [T]he transmission of data over a local telephone network, or similar communication or transmission service, is contained within the definition of 'network telephone service.'"

The taxpayers argue such an interpretation is contrary to legislative intent. The taxpayers cite *Western Telepage, Inc. v. Tacoma*, 140 Wn.2d 599, 998 P.2d 884 (2000), in support of their argument that the legislative intent was to extend the scope of the network telephone tax, in addition to traditional telephone companies, to companies providing telecommunications services in the wake of federal deregulation of the telecommunications industry. In *Western Telepage*, the court stated:

The legislature intended to complete what it had begun in 1981, i.e. the deregulation of the telephone business and the equalization of tax burdens on all businesses engaging in the telephone business without regard to whether the business was regulated or non-regulated.

In issuing the assessments, the Audit Division relied on Det. No. 00-159E, 20 WTD 372 (2001). In that determination, the taxpayer operated a shared wide area network (“WAN”) (a system in which computers on the system can communicate with other computers on the system). Shared WANs share data transmission resources and may also share computer processing resources. Each computer on the WAN was linked by data transmission facilities utilizing either leased lines or packet-switched networks. The taxpayer’s customers had computers on their premises that were linked to the taxpayer’s shared WAN. We concluded that the taxpayer’s shared WAN services were network telephone services. We explained:

Taxpayer clearly transmits data or information for hire. Taxpayer’s customer supplies the data or information, and Taxpayer’s shared WAN transmits the data from a computer in one location to a different computer in another location. The fact that taxpayer may contract with an underlying telecommunications carrier for the telephone lines that actually transmit the data is not determinative. What is determinative, however, is that the customer holds Taxpayer responsible for the eventual transmission of the computer data or information to its final destination. If the computer data is not received, the customer would look to Taxpayer for restitution and/or compensation and not the underlying carrier.

In contrast, the taxpayers cite Det. No. 98-202, 19 WTD 771 (2000), in support of their argument that the fact that they use telephone lines to transmit data does not change the “true object” of their activities from information services to network telephone services. Det. No. 98-202 involved a travel agency that leased a computer to make reservations. The monthly fee it paid was broken down into computer hardware, software license and support, and communication support (which was a charge for having access to the reservation system and database). The reservation system allowed the taxpayer to receive current information on airline, hotel, and rental car availability and prices and to book the reservation with the service provider. The monthly charge included but did not separately state the cost of telephone lines necessary to connect the taxpayer’s terminal to the reservation system.

In Det. No. 98-202, the Audit Division assessed retail sales tax on the travel agency’s entire payment to the reservation service because it contended that the inclusion of the telephone line charges converted the entire charge to network telephone services. However, the Department concluded that the communication support charge was properly classified under the service classification because it involved a charge for providing computer services. The Department further concluded that the telephone line charges were only incidental to the services the taxpayer

received and could not be bifurcated and taxed separately from the “true object” of the transaction, which was the ability to access the information in the reservation system to make reservations.

We conclude that Det. No. 98-202 is closely analogous to the facts here. Specifically, the taxpayers here provide pharmacies and hospitals access to insurance information and submit insurance claims for their customers. In submitting the claims, the taxpayers reformat the data as necessary. The taxpayers then report back to their customers whether their claims were approved or denied. Similarly, the taxpayer in Det. No. 98-202 received access to reservation information, was able to submit reservation requests, and received information regarding whether the reservations were accepted.

In reaching this conclusion, we distinguish *Western Telepage, Inc. v. City of Tacoma*, 140 Wn.2d 599, 998 P.2d 884 (2000). At issue in that case was whether the taxpayer’s provision of paging services was subject to tax as network telephone services. The paging service transmitted numeric and alpha-numeric messages to customers. Generally, a numeric message was transmitted in response to a telephone call made to a customer’s pager access number; a telephone company would then transmit the call to the taxpayer’s paging terminal. Alpha-numeric messages were prompted by messages sent to the paging terminal via modem, dictation to a live operator, and e-mail. For either the numeric or alpha-numeric messages, the taxpayer’s paging terminal sent a microwave (radio) transmission to the pager device, advising the caller to return a call to the specified telephone number or transmitting the brief alpha-numeric message. The court concluded such services were properly classified as network telephone services because they transmitted data or similar communication by microwave. In other words, the taxpayer provided the medium over which the data was communicated. As explained above, the taxpayers’ services do not entail simply providing the medium for the transmission of data; instead, the taxpayer provides new information to its customers.

Similarly, we distinguish Det. No. 88-193, 5 WTD 347 (1988).⁵ In that determination, the taxpayer received its income from transmitting data from an earth station to a satellite and from a satellite to a hub. Like the taxpayer in *Western Telepage*, the taxpayer in Det. No. 88-193 provided the medium for transmitting data. There was no evidence that the taxpayer added any information to the data provided by its customers.

Accordingly, we conclude that . . . the taxpayers’ income . . . from data processing and related services . . . is subject to Washington taxation under the service classification.

. . . The taxpayer is entitled to apportion its income subject to tax under the service classification if it maintains “places of business” both within and without this state. *See* RCW 82.04.460. . . .

⁵ *See also* Det. No. 92-363, 12 WTD 519 (1992).

CONCLUSIONS OF LAW AND DISPOSITION:

The taxpayers' petition is granted in part and denied in part.

Dated this 15th day of December, 2005.